United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-6173

To be argued by
FREDERICK P. SCHAFFER

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-6173

ATLANTIC DEPARTMENT STORES, INC.,
Plaintiff-Appellee,

—v.—

UNITED STATES OF AMERICA,
Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE DEFENDANT-APPELLANT

ROBERT B. FISKE, JR.,
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BRIEF FOR THE DEFENDANT-APPELLANT

Issue Presented

Is an employer entitled to a refund for the full amount of the overpayments of the employer tax under the Federal Insurance Contribution Act ("FICA") despite its failure to repay or reimburse the overpayments of the employee tax to those employees who were still in its employ at the time the overpayments were ascertained?

Statement of the Case

This action was commenced on August 26, 1975 by Atlantic Department Stores, Inc. ("Atlantic") to recover from the Government an overpayment of FICA taxes made by Atlantic pursuant to section 3111 of the Internal Revenue Code of 1954 (the "Code"), 26 U.S.C.

§ 3111, for the calendar year 1974 (A. 3-7).* The Government filed its answer on October 28, 1975 (A. 8-9). On April 16, 1976, the Government moved to dismiss the complaint for failure to state a claim upon which relief could be granted, or in the alternative for judgment on the pleadings (A. 10-12). On May 11, 1976 Atlantic cross moved for summary judgment (A. 13-26). A stipulation and order of facts pertaining to said motions was filed on August 13, 1976 (A. 27-29). On August 19, 1976, the District Court, per Honorable Marvin E. Frankel, filed its opinion denying the Government's motion to dismiss and granting Atlantic's cross motion for summary judgment (A. 30-36). Accordingly a judgment was entered on August 31, 1976 awarding Atlantic recovery in the amount of $11,636.10 with interest from the date of the overpayment (A. 37-38). On October 28, 1976 the Government filed its notice of appeal (A. 39-40).

The facts of this case are undisputed and may be summarized as follows: Pursuant to sections 3101, 3102, and 3111 of the Code, 26 U.S.C. §§ 3101, 3102, and 3111, an employer is required to pay the employer FICA tax based on a percentage of the wages paid to its employees and to withhold and pay over to the Government the employee FICA tax in the same amount. During the year 1974, Atlantic erroneously treated as wages subject to the FICA tax sick leave payments made to 2409 employees. As a result, Atlantic overpaid the employer tax by $11,636.10 and made an overpayment of the employee tax which had previously been withheld from its employees' wages in the same amount (A. 27). The average overpayment per employee was

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* Page citations preceded by the letter "A." refer to the Joint Appendix.

$4.83 (A. 27). After filing its returns and making the required payments for the year 1974, Atlantic had its returns audited by a tax advisory service at which time the overpayments were discovered (A. 16, 18). On June 16, 1975, Atlantic made a claim for refund of its overpayment of the employer's share of the FICA tax for 1974 (A. 27). That claim was denied on July 10, 1975 (A. 16). At the time Atlantic filed its claim for refund, only 11% of the employees from whom Atlantic had overwithheld the FICA tax were still in its employ (A. 28). For those employees whose location was known and who were cooperative, the estimated cost to Atlantic of computing the precise amount of the overcollection from each employee and effecting repayment by mail would be almost half of the average overpayment per employee; where employees could not be located or were uncooperative, the cost might exceed the total amount of the claim (A. 28-29).

In its opinion, the District Court held that there is nothing in the applicable provisions of the Internal Revenue Code or the regulations promulgated thereunder which imposes a general obligation upon the employer to claim a refund or credit on behalf of its employees in order to obtain a refund or credit for its own overpayment of the FICA tax and that no such obligation should be implied as a matter of equity (A. 32-35). The Court recognized, however, that under section 6413(b) of the Code, 26 U.S.C. § 6413(b), a refund may be had only when the overpayment cannot be adjusted as required by section 6413(a)(1) of the Code, 26 U.S.C. § 6413(a)(1) (A. 35). The Court also noted that under Treas. Reg. § 31.6413(a)-2(b), in order to adjust its own overpayment, on employer is required to repay or reimburse its employees the amount of their overpayments and to claim a credit for the overpayments of both the employer and employee tax in a subsequent return (A. 35). Nevertheless, the Court concluded that

in light of the fact that 89% of the employees were no longer employed by Atlantic on the date it filed its claim for a refund, thereby rendering impossible a reimbursement to those employees, and that the cost of effecting a repayment would be half or more of Atlantic's claim with respect to each employee, this was a case where "overpayment cannot be adjusted" (A. 35).*

For the purposes of this appeal, the Government does not challenge the District Court's holding that Atlantic has no equitable obligation to file a claim for refund or credit on behalf of its employees or that an adjustment cannot be made with respect to the employees who had left by the time Atlantic ascertained the overpayments. The Government does dispute, however, the District Court's conclusion that the overpayments could not have been adjusted with respect to the employees who still worked for Atlantic when the overpayments were ascertained. In light of the fact that the record does not reveal when Atlantic's auditors discovered the overpayments and what percentage of the employees affected were still working for Atlantic at that time, the Government submits that the judgment below should be vacated and the case remanded for a determination of those factual issues in order to establish the correct amount of the refund to which Atlantic is entitled.

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* An employer "repays" the amount overcollected by making a cash payment directly to the employee; an employer "reimburses" the amount overcollected by applying that sum against the employee's FICA tax liability for the return period following the one in which the error was ascertained. Treas. Reg. § 31.6413(a)-1(b)(1)(iii).

Applicable Statute and Regulations

Internal Revenue Code of 1954, 26 U.S.C.:

§6413. Special rules applicable to certain employment taxes.

(a) Adjustment of tax.

(1) General rule.

If more than the correct amount of tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment or remuneration, proper adjustments, with respect to both the tax and the amount to be deducted, shall be made, without interest, in such manner and at such times as the Secretary or his delegate may be regulations prescribe.

* * * * *

(b) Overpayments of certain employment taxes.

If more than the correct amount of tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid or deducted with respect to any payment or remuneration and the overpayment cannot be adjusted under subsection (a) of this section, the amount of the overpayment shall be refunded in such manner and at such times (subject to the statute of limitations properly applicable thereto) as the Secretary or his delegate may by regulations prescribe.

Treasury Regulations, 26 C.F.R.:

§ 31.6413(a)-1 Repayment by employer of tax erroneously collected from employee.

* * * * *

(b) *After employer files return*—(1) *Employee tax under the Federal Insurance Contributions Act or the Railroad Retirement Tax Act.* (i) If an employer collects from any employee and pays to the district director more than the correct amount of employee tax under section 3101 or section 3201, or a corresponding provision of prior law, and if the error is ascertained within the applicable period of limitation on credit or refund, the employer shall repay or reimburse the employee in the amount thereof prior to the expiration of the return period following the return period in which the error is ascertained and prior to the expiration of such limitation period. This subparagraph has no application in any case in which an overcollection is made the subject of a claim by the employer for refund or credit, and the employer elects to secure the written consent of the employee to the allowance of the refund or credit under the procedure provided in paragraph (a)(2)(i) of § 31.6402(a)-2.

(ii) If the amount of an overcollection is repaid to an employee, the employer shall obtain and keep as part of his records the written receipt of the employee, showing the date and amount of the repayment. If, in any calendar year, an employer repays or reimburses an employee in the amount of an overcollection of employee tax under section 3101, or a correspond-

ing provision of prior law, which was collected from the employee in a prior calendar year, the employer shall obtain from the employee and keep as part of his records a written statement (a) that the employee has not claimed refund or credit of the amount of the overcollection, or if so, such claim has been rejected, and (b) that the employee will not claim refund or credit of such amount. See § 31.6413(c)-1.

(iii) If the employer does not repay the employee the amount overcollected, the employer shall reimburse the employee by applying the amount of the overcollection against the employee tax which attaches to wages or compensation paid to the employee prior to the return period following the return period in which the error is ascertained and prior to the expiration of the applicable period of limitation on credit or refund. If the amount of the overcollection exceeds the amount so applied against such employee tax, the excess amount shall be repaid to the employee as required by this subparagraph.

(iv) For purposes of this subparagraph, an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

(v) For the period of limitation upon credit or refund of taxes imposed by the Internal Revenue Code of 1954, see § 301.6511(a)-1 of this chapter (Regulations on Procedure and Administration). For the period of limitation upon credit or refund of any tax imposed by the Internal Revenue Code of 1939, see the regulations applicable with respect to such tax.

* * * * *

§ 31.6413(a)-2 Adjustment of overpayments.

(a) *Taxes under the Federal Insurance Contributions Act or the Railroad Retirement Tax Act*—(1) *Employee tax.* After an employer repays or reimburses an employee in the amount of an overcollection, as provided in paragraph (b)(1) of § 31.6413(a)-1, the employer may claim credit for such amount in the manner, and subject to the conditions, stated in § 31.6402(a)-2. Such credit shall constitute an adjustment, without interest, if the amount thereof is entered on a return for a period ending on or before the last day of the return period following the return period in which the error was ascertained. No credit or adjustment in respect of an overpayment shall be entered on a return after the filing of a claim for refund of such overpayment.

(2) *Employer tax.* If an employer pays more than the correct amount of employer tax under section 3111 or section 3221, or a corresponding provision of prior law, the employer may claim credit for the amount of the overpayment in the manner, and subject to the conditions, stated in § 31.6402(a)-2. Such credit shall constitute an adjustment, without interest, if the amount thereof is entered on the same return on which the employer adjusts, pursuant to subparagraph (1) of this paragraph, a corresponding overpayment of employee tax.

* * * * *

ARGUMENT

Atlantic Was Not Entitled To A Refund For The Full Amount Of Its Overpayments Of The Employer FICA Tax Where It Had Failed To Repay Or Reimburse The Overpayments Of The Employee Tax To Those Employees Still Employed By Atlantic At The Time The Overpayments Were Ascertained.

The District Court held that Atlantic was entitled to a refund for the full amount of its overpayments of the employer FICA tax for 1974 despite its failure to repay or reimburse the overpayments of the employee tax to those employees who were still in the employ of Atlantic on the date that the overpayments were ascertained. This holding is contrary to the language and intent of both the applicable statute and the regulations promulgated thereunder.

Section 6413(a)(1) of the Code, 26 U.S.C. § 6413 (a)(1) requires that with respect to overpayments of FICA taxes, "proper adjustments, with respect to both the tax and the amount to be deducted, shall be made, without interest, in such manner and at such time as the Secretary or his delegate may by regulation prescribe." Section 6413(b) of the Code, 26 U.S.C. § 6413(b), contains an exception to that requirement by permitting refunds where "the overpayment cannot be adjusted" under section 6413(a). As the District Court recognized, these provisions mean that an employer is not entitled to a refund on the overpayments of its FICA tax unless proper adjustments have been made as provided in the applicable regulations except where "the overpayment cannot be adjusted" (A. 35). There is no question on this appeal that Atlantic failed to make the required adjustments. The only issue, then, is whether with

respect to employees still working for Atlantic at the time the overpayments were ascertained, the administrative costs of reimbursement or repayment were such as to render adjustment impossible.

The legislative history of the predecessors of section 6413(a) and (b)* indicates that Congress assumed that an employer would remedy errors in connection with taxes on its employees' wages by adjusting subsequent wage payments:

> "[Section 6413(a)] permits the employer to correct errors in the tax reported in connection with any wage payment to his employees by making proper adjustments in connection with subsequent wage payments." S. Rep. No. 628, 74th Cong., 1st Sess. at 43; H. Rep. No. 615, 74th Cong., 1st Sess. at 30-31.

In view of that assumption, Congress created the exception to the adjustment requirement because of a concern with the situation where an employee had left the service of an employer after the overpayment was discovered:

> "[Section 6413(b)] relates to the tax imposed with respect to both employers and employees. If any part of the employer's or employee's taxes is . . . overpaid and the error cannot be adjusted in connection with subsequent payments . . . the overpayment [is to be] refunded under regulations prescribed under this title. Situations of this

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* These provisions were carried over without material change from Sections 1411 and 1421, respectively, of the 1939 Code. H. Rep. No. 1337, 83d Cong., 2d Sess. at 412; S. Rep. No. 1622, 83d Cong., 2d Sess. at 582. The 1939 Code provisions originated as sections 805 and 806 of the Social Security Act of 1935, c. 531, 49 Stat. 620.

> character will usually arise when an employee leaves the service of the employer so that it is impossible to make adjustments in subsequent wage payments." *Id.*

Pursuant to the mandate of section 6413(a)(1), the Secretary of the Treasury has promulgated regulations governing the manner in which adjustments are to be made. An adjustment of the employee tax is made by repaying or reimbursing the employees from whom the tax was overcollected and then by claiming an appropriate credit on a return for the period following the return period in which the error is ascertained.* Treas. Reg. § 31.6413(a)-2(a). An adjustment of the employer tax is made by claiming an appropriate credit on the same return on which the corresponding credit of the employee tax is claimed. Treas. Reg. § 31.6413(a)-2(b). Thus, an adjustment of the employer tax can be made only by making a corresponding adjustment of the employee tax. As the District Court correctly summarized the procedure required in this case:

> "To make an adjustment of its own overpayment, an employer must first repay or reimburse each employee for the amount of the employee's overpayment, and then claim credit for the amount of overpayment of *both* employer and employee tax in a subsequent return" (A. 35).**

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* According to the regulations, "an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it." Treas. Reg. § 31.6413(a)-1(b)(1)(iv).

** It should be noted that there is an exception to this procedure where "an overcollection is made the subject of a claim by the employer for refund or credit, and the employer elects to secure the written consent of the employee to the allowance of the refund or credit under the procedure provided in paragraph (a)(2)(i) of § 31.6402(a)-2." Treas. Reg. § 31.6413(a)-1(b)(1)(i).

The obvious rationale behind these requirements is that overpayments of the FICA tax are necessarily the result of an error by the employer, and it is generally the employer who will later ascertain the error and who will have the greatest financial incentive to claim a refund; thus the burden may properly be placed on the employer to rectify the overcollection where possible.

In order to protect against fraud or double recovery of overpayments, the regulations also provide that the employer should obtain and keep as part of its records receipts from employees evidencing repayment of the amounts overcollected. In addition, where the repayment or reimbursement was made with respect to the employee tax collected in the prior calendar year, the employer is required to obtain statements from the employees demonstrating that they have not claimed a refund or, if they have, that their claim has been rejected and that they will not claim a refund of the amounts overcollected. Treas. Reg. § 31.6413(a)-1(b)(1)(ii).

With respect to the employees who were still working for Atlantic, the District Court held that the administrative costs of effecting the required adjustments, as a percentage of the average overpayment per employee, renders this a situation where "the overpayment cannot be adjusted" within the meaning of section 6413(b). However, the language of that section refers to the impossibility of adjustment, not to its cost. As noted above, the legislative history of section 6413(b) indicates a Congressional concern with employees who had left the taxpayer's employ; there is nothing to suggest that the burden of making proper adjustments with respect to employees still working for the taxpayer was considered.

Moreover, section 6413(a)(1) specifically authorizes the Secretary to promulgate regulations as to the manner

in which adjustments shall be made. In light of this express delegation of rule-making authority, the regulations thereunder are legislative in character and have the force and effect of law unless they clearly violate the provisions of the Code, are in excess of the authority delegated, or are unreasonable and arbitrary in their application. See *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948); 1 Mertens, Law of Federal Taxation § 3.20 (1969). Where, as here, there has been no challenge to the validity of the regulations, it simply cannot be maintained, as a matter of statutory construction, that the cost of complying with them excuses such compliance under the statute that authorizes their promulgation in the first place. The District Court therefore erred in considering the cost of effecting adjustments as required by the Code and as prescribed by the regulations as a reason for concluding that such adjustments were impossible with respect to employees still working for the employer at the time the overpayments were ascertained.

In addition, consideration of the cost of making the required adjustments raises a number of practical difficulties. In the first place, it is not clear whether the appropriate factor should be the cost in relation to the amount of the overpayment, or in relation to the employer's financial condition. Even assuming, as the District Court did, that it is the former measure which is the relevant one, the question arises as to where the line is to be drawn to distinguish a disproportionate cost from a permissible one. The resolution of that question is further complicated by its possible dependence on the absolute amount of the overpayment, since a 50% cost may have a different impact where the overpayment is $10 million rather than $10 thousand. In short, there are no guidelines by which the courts, employers, or the Internal Revenue Service can consider cost as a factor in determining whether in a particular case compliance with the adjustment requirement is excused.

Finally even if the cost of making the required adjustments may be considered in deciding whether the overpayments can be adjusted, not all of the expenses whose amounts were stipulated to by the parties were properly taken into account by the District Court in this case. Almost half of the estimated cost for Atlantic to adjust the overpayment for each of its employees ($1.00 out of $2.25) was for the "original investigation to determine overdeduction and quarter in which overdeduction was made" (A. 29). However, that computation was obviously necessary in order to compute the total amount of the overpayment. Furthermore, a statement containing this information (and more) is required by Treas. Reg. § 31.6402(a)-2(c) to accompany any claim for the refund of an overpayment of either the employer or employee FICA tax independently of the adjustment requirement. Indeed such a detailed statement as to each employee from whom an overcollection was made was in fact submitted by Atlantic as part of its refund claim.* Thus, the District Court erred in considering this element as a cost imposed by the adjustment procedure set forth in Treas. Reg. § 31.6413(a)-2(b). Similarly, at least another 20% of the estimated cost ($.45 out of $2.25) pertains to mailing expenses.** With respect to employees still working for Atlantic, it would not appear necessary for the communications to have occurred by mail. Thus, the cog-

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* These statements, contained on Form 941c, were the supporting schedules referred to in paragraph EIGHTH of the complaint herein and omitted from Exhibit A annexed thereto (A. 4).

** The stipulation by the parties allocates $.80 to "Printing, stationery, mailing expense" and $.30 to "Follow up mailings" (A. 29). For purpose of this analysis, it is assumed that only $.15 out of the $.80 is attributable to "mailing expense" although the figure might well be higher.

nizable and necessary cost of effecting the required adjustments for employees still working for Atlantic would appear to be $.80, not $2.25; that is, one-sixth rather than almost one-half of the average overpayment per employee.

In sum, as a matter of law and of fact, the cost to Atlantic of making the required adjustments to the employees still working for it does not render this a case where the overpayments cannot be adjusted. The question remains, however, as to the time at which the employees still employed by Atlantic should be determined. The District Court referred to the percentage of employees still employed as of the date the refund claim was filed because that was the only date for which there is evidence in the record. However, in view of the statutory purpose to effectuate adjustments whenever possible, the most appropriate date for determining the employees still working for the employer is the date the overpayments are ascertained. Although the regulations provide that employees may be repaid or reimbursed at any time prior to the expiration of the return period following the return period in which the error is ascertained and prior to the expiration of the applicable period of limitation, Treas. Reg. § 31.6413(a)-1(b)(1)(i), the use of any date subsequent to the date the error was ascertained conflicts with the statutory purpose by creating an incentive for employers to delay making the proper adjustments. In the instant case, the error was ascertained when the tax advisory service retained by Atlantic informed it of the overpayment. Since the record in this case does not indicate that date or the employees still working for Atlantic at that date, the case should be remanded to the District Court for a determination of these facts and the entry of an appropriate judgment based thereon.

CONCLUSION

The District Court erred in holding that Atlantic was entitled to a refund for the full amount of its overpayment of the employer FICA tax where it had failed to repay or reimburse the overpayments of the employee tax to those employees still employed by Atlantic at the time the overpayments were ascertained. Accordingly, the judgment below should be vacated and the case remanded for the determination of the date the error was ascertained and the employees still working for Atlantic on that date.

Dated: New York, New York
February 14, 1977

Respectfully presented,

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Form 280 A-Affidavit of Service by Mail
Rev. 12/75

AFFIDAVIT OF MAILING

State of New York)
County of New York) ss

CA 76-6173

Pauline P. Troia, being duly sworn, deposes and says that she is employed in the Office of the United States Attorney for the Southern District of New York.

That on the 14th day of February 19 77 she served 2 copies of brief & 1 copy of joint appendix of the within govt's brief and the joint appendix

by placing the same in a properly postpaid franked envelope addressed:

Kaplan & Abrahams, Esqs.,
200 Garden City Plaza,
Garden City, NY 11530

And deponent further says she sealed the said envelope and placed the same in the mail drop for mailing in the United States Courthouse Annex, One St. Andrews Plaza, Borough of Manhattan, City of New York.

Pauline P. Troia

Sworn to before me this

14th day of February, 19 77

Ralph I. Lee

RALPH I. LEE
Notary Public, State of New York
No. 41-2292838 Queens County
Term Expires March 30, 1977